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SUBJECT: The Economy in 2003: Triumph of Politics

¶1. Summary. The economic outlook for the New Year is cloudy. Academic experts and business leaders fear that Nigeria will experience little if any real per capita growth in 2003. They bemoan Nigeria's OPEC oil production quota of 1.9 million barrels per day, which limits the country's potential oil exports. These experts fear even more what they say are irresponsible fiscal policies despite President Obasanjo's relative frugality. Central Bank data show that such policies are putting Nigeria on shaky economic ground as it heads toward 2003. Nigerian economists we have talked to do not expect a policy change during the next quarter, which will be the last before critical federal and state elections in April 2003. End summary.

Real Economy

¶2. The economic clouds of 2002 have obscured the view of likely economic activity in the New Year. In early November 2002, IMF experts estimated that Nigeria's gross domestic product would decline 0.9 percent in real terms in 2002 owing to falling oil revenues. This figure, if confirmed, will be in stark contrast to the 3.8 percent growth achieved in 2001. The Central Bank has challenged the IMF figure and forecasts 3.2 percent growth for 2002. Its basis for optimism is that non-oil sector output may have risen 5.3 percent in 2002, buoyed by a 4.1 percent increase in agricultural production owing to favorable rainfall. (The discrepancy points to the weak database and less than robust analysis.) The GON also points to the dynamism of the telecommunications sector, which was energized by deregulation and the introduction of GSM telephone systems. Both the IMF and the GON recognize that the manufacturing sector remained weak in 2002, as capacity utilization did not exceed 41 percent during the year. Partly because of this fact, there is increasing consensus among Nigerians on the need to accelerate privatization, and market determination of the exchange and interest rates. The Dutch Action System (DAS), which was introduced in mid 2002 to deal with the pressure on the exchange rate, has facilitated improved management of the exchange rate.

¶3. Whether one uses the IMF or Central Bank figures, the data still point to a setting in which purchasing power remains weak. Not only is the annual per capita income of the Nigerian population estimated to be below 300 USD, its rate of growth approximates only 2.8 percent a year. Consequently, the optimistic 3.2 percent growth results in only a 0.4 percent rise in per capita income under the better of the two scenarios mentioned above. At such a low rate of increase, Nigerians are condemned virtually to perpetual poverty. It is a far cry from the 7.2 percent real per capita income growth that Nigerians would need to experience continually over the next ten years to double their income within a decade.

¶4. To achieve 7-10 percent real growth in any given year calls for an environment conducive to business. Last year's has not been so, according to Doyin Salami, a macroeconomics professor at the Lagos Business School. In mid-November, he shared data with us and business executives that showed that private sector turnover had just kept pace with inflation during the first half of 2002. A Lagos Business School survey of fast moving consumer goods then disclosed that the fastest moving items (like powdered milk) were necessities being packaged in ever smaller containers to be within reach of consumers' falling purchasing power. Expenditure switching was associated with this decline in sales volume, Salami asserted. Companies marketing consumer goods had to lower their margins in 2002 to attract buyers since many poor people chose to buy goods like GSM telephones rather than essential items, notwithstanding their low level of income.

Consequently, unadjusted profits for the non-financial sector fell by 6.4 percent during the period, he said. The ratio of losers to winners during this time was three to one, he added. A report appearing in the December 30 issue of Business Day carried the headline, "Economic Lull Impacts on Companies' Profits."

¶5. Except for cases in which the purchase of cellular phones facilitates earning a living, other instances of inessential purchases may rightly be considered conspicuous spending. Such spending affects aggregate growth only at the margin. The reason is simple: there are simply too few Nigerians with substantial purchasing power. Salami and his better-known colleague at the business school, Pat Utomi, presented data bearing out this point. Regarding distribution of wealth, Salami said the richest four-percent of the population in Nigeria possesses 48 percent of the country's wealth. The next cohort accounts for 46 percent of the population and holds 44 percent of the wealth. The bottom 50 percent of the population accounts for 8 percent of the wealth. This highly skewed distribution of wealth is sub-optimal with respect to economic growth. Since the richest cohort's propensity and ability to import is much larger than that of the other two- thirds of the population, much of the income of the top four percent of the population helps to sustain foreign economies, not Nigeria. But this group is numerically so small that it absorbs little of Nigeria's manufactured products. This group also generally disdains Nigerian goods and will buy imported items whenever it can, further compounding the problem. Its savings or surplus income, which accounts for a large proportion of total private savings, is consequently often channeled abroad. Such capital flight further holds back Nigeria's economic growth.

¶6. There is another dysfunctional form of conspicuous spending in Nigeria: that for political position. In many other countries, people with money invest in industry or services as these sectors of economic activity generate wealth. In Nigeria, however, many people with money invest directly in the political sector or indirectly by backing politically ambitious individuals. It is common knowledge that in Nigeria politics can be the short road to massive wealth. How else can one account for the substantial cost of recent electoral activity in Nigeria? Funding of it, whether originally through a draw down of foreign exchange reserves, has been distributed primarily in naira to advance the political prospects of various people. An Emboff's informed estimate of the cost of the Peoples Democratic Party convention in Abuja last week is that it approximated 60 million USD.

¶7. Continuing in this vein, Utomi added that statistics show that funding for the federal, state, and local governments has quadrupled since 1998, yet little of it is used productively. (Central Bank data confirm that the revenues that accrued to the state and local governments increased by a factor of four in nominal terms during 1997-2001. Federal government revenues nearly doubled during the same period. The greater distribution of revenue to state and local governments during the Fourth Republic (relative to the distribution in 1997-1998 during military rule) is partly the result of a requirement imposed on the federal government by the 1999 constitution.) To make his point, Salami referred to a value-for-money audit that the IMF and the World Bank conducted in Nigeria and said its value-for-money index was put at fourteen percent at the Conference on Development that was held in Monterrey, Mexico in March 2002. Consequently, little of the government revenue allocated to economic and social services has the intended effect. (Comment. We were told that a value-for-money coefficient of 14 signifies that only 14 out of every 100 naira collected by the federal government is spent effectively. End comment.) According to Utomi, no more than a tenth of the 100,000 young men and women who graduate from Nigeria's post-secondary institutions every year obtain adequate urban employment within one year of graduation, for example. Few of these adults find meaningful alternative employment in the rural sector since the wages are too low to attract them. Rural wages remain low partly because forty percent of total agricultural production is lost owing to inadequate infrastructure.

Fiscal Policy

¶8. Nigeria's less-than-reassuring fiscal policies are the cause of the overcast 2003 outlook. The central government's overall budget deficit target for 2002 was set at -446 billion naira (about 3.7 billion USD). Reviewing the performance of the federal government during the first part of the year, Salami showed that the overall fiscal balance stood at minus N119.5 billion (about 1.0 billion USD), which equaled 4.3 percent of GDP (assuming 3.2 percent real growth in 2002). This figure for the deficit appeared in the Central Bank's report for the first half of 2002. Should it turn out that the target figure for 2002 was realized, fiscal policy will have been as expansionary in 2002 as any policy of the last four years. Although oil revenues were 36 percent lower during the first half of 2002 than during the first half of 2001 because Nigeria's OPEC quota limited its export volume, federal government revenues still exceeded the budget estimate by 29.7 percent in the first six months of 2002. However, recurrent expenditures alone rose 14 percent during the period relative to those of the first half of 2001. The total of recurrent expenditures and the federal government's capital expenditures and net lending "resulted in a large monetary financing of a huge deficit" during the first half of 2002, according to the Central Bank. More recent Central Bank data indicate that recurrent expenditures accounted for 77.7 percent of the central government budget and exceeded the target by 10.6 percent during the first ten months of 2002. Personnel costs associated with a bloated civil service accounted for 70 percent of these recurrent expenditures.

¶9. The Central Bank's announcement of late December that the federal government had recorded a deficit of 47.5 billion naira (about 400 million USD) during the first ten months of 2002 was unexpected, given that the budget deficit for the first semester 2002 totaled 119.5 billion naira. The reason for the remarkable turnaround was the inclusion in the government's retained revenue of the proceeds of the sale of external reserves and of borrowing from the banking system. As noted in the Bank's report for October, "in the ten-month period, the Federal Government substantially drew down on its deposits with the Central Bank of Nigeria, resulting in further injection of liquidity in the banking system." Although Obasanjo slashed capital expenditures during the first nine months of 2002, we expect that the data for the last quarter will show that the federal government's net lending, capital expenditures, and transfers to state and local governments will have picked up in 2002. We further expect that this trend will continue during the first six months of 2003 because of expenditures associated with contracts typically awarded at the end of a presidential administration and other handouts of patronage.

Monetary Policy

¶10. Nigerian analysts know that the Central Bank has the unenviable task of ensuring that monetary policy accommodates fiscal policy. Although the rate of growth of the monetary aggregates had slowed during the first six months of this year relative to the figures for the first half of 2001, by the end of October broad money (M2) had risen by 32 percent against a target of 15.3 percent for 2002. The increases were driven by excessive bank credit to the domestic economy; primarily government credit, which rose 602.1 percent during the first six months of this year relative to the corresponding period a year ago. The Central Bank itself subscribed to 45 percent of the treasury bills issued during the period. Reflecting the government's inability or unwillingness to make further cuts in the budget in the light of a continuing budget deficit, government borrowing picked up during the subsequent four months (July-October) of 2002. Central Bank data for October show that government credit rose a whopping 836 percent during the first ten months of 2002.

¶11. The crowding out of the private sector has thus been an important feature of the money and capital markets in 2002. Bank credit to the private sector rose by only 8.7 percent in the first ten months of the year, a far cry from the annual target of 34.9 percent. Equally important was the fact that non-bank public subscription to treasury bills rose by a factor of ten in the first half of 2002 relative to the corresponding period the year before. (The Central Bank's and commercial banks' subscriptions to treasury bills rose by a factor of seven during the same period.) While it

may have appeared that the Central Bank's reduction of the Minimum Rediscount Rate (MRR) by 400 basis points in late October, to 18.5 percent, would stimulate private sector lending, the reduction also lowered the cost of government borrowing and so may have encouraged such further borrowing. For these reasons, the cut in the MRR late in the year is particularly worrisome; such action is counter-intuitive since the budget deficits have caused the liquidity overhang.

¶12. Bowing to political pressure, the Central Bank of Nigeria (CBN) nonetheless further reduced the rediscount rate to 16.5 percent in late December and called on banks to lower the prime lending rate to MRR + 400 basis point. Unpublished preliminary data of the Central Bank that we saw on December 30 indicate that this reduction in the MRR has lowered inter-bank lending rates. Rates have come down partly because the first tranche of the December 2002 statutory federal government allocation to the state and local governments trickled into bank vaults in late December. Professor Salami and other economists we have talked to caution that the lower rates are unlikely to hold since inflation and default risk drives interest rates. Since neither of these two drivers will lose momentum during the next six months, lending rates will remain high as institutional investors flock to treasury bills in a flight to quality. Moreover, deposit banks are likely to find ways to increase their lending rates, Salami said. He anticipates the development of an underground market in which loans will be extended at MMR plus 400 basis points plus a premium to take account of erosion of asset values induced by an expected rise in inflation early next year. An Emboff already knows of an instance in which a contact of his who wants to import equipment to process cashews asserted that he was recently quoted a rate of interest of 35 percent, plus a 2 percent charge for documentation, and a 5 percent transfer charge. The interest rate plus the charges total 42 percent, a far cry from the 20.5 prime interest rate that the Central Bank is recommending.

Foreign Account

¶13. Central Bank data show that Nigeria's trade surplus declined 45.3 percent during the first half of 2002-to 2.6 billion USD-relative to the corresponding period the year before. During the first six months of 2002, export revenue declined 40 percent, to 6.5 billion USD, and imports fell 35 percent. The invisibles account (services and income) totaled about -4.0 billion USD and current transfers equaled 697 million USD during the first six months of 2002. Consequently, the current account deficit totaled 714 million USD compared to a 1.35 billion USD surplus during the corresponding period in 2001. As a result, foreign exchange reserves fell from 10.45 billion USD at the start of the year to 8.7 billion USD at the end of June 2002. At the end of October, Nigeria's foreign reserves totaled about 8.0 billion USD. A review of Central Bank data shows that the expected trade, current account, and overall account figures for 2002 are likely to be as bad as any data of the last three years.

¶14. To stanch the expected outflow, the Central Bank in July began allocating foreign exchange through a Dutch Auction System, which has narrowed the gap to about ten points between the parallel and official rates of exchange throughout fall 2002. But pressure has built up and there is no reason to expect it to decline. The Central Bank recently re-authorized twenty-one banks to buy foreign exchange, lifting a ban ahead of time that had forbade these banks from engaging in such transactions owing to violations of foreign exchange regulations. The demand for forex by these banks will put pressure on the naira and may lead to further depreciation. Consequently, and given the political uncertainty ahead, we expect that a larger than normal volume of funds will flow out of the capital and money markets and into the foreign exchange market during the next several months. Such movement will test the recent stability in the foreign exchange market, as funds drift out of the money and capital markets in response to the uncertain electoral prospects in spring 2003.

¶15. In the light of the developments mentioned above, Professor Salami warns that Nigeria is experiencing a "lull before a damaging storm." He cautions that the central government might soon find itself unable to use foreign reserves as the primary mechanism to manage the

exchange rate. Nigeria's foreign reserves rose slightly in November relative to October, but the volume remains close to the CBN's self-imposed minimum six-month limit necessary to sustain imports. We expect a further temporary rise in foreign exchange as a result of the recent spike in oil prices and slightly larger OPEC quota for Nigeria, which will yield larger revenues, and repatriated funds associated with the end of year holidays. These flows, associated with the seasonal weakening of demand for forex by manufacturers, have led to a temporary appreciation of the naira that is unlikely to be sustained for the reasons mentioned above. Should reserves fall much below that floor, the government will have no choice but to look for other adjustment mechanisms in 2003. These might comprise extensive import bans and tightening of foreign exchange regulations (which would again widen the differential between the official and parallel markets).

Prospects for 2003

¶16. Salami suggested enigmatically that 2003 be called the Year of Two Halves. He, like several other analysts that we have talked to, expects that expansionary fiscal policy will characterize the first half of 2003. Salami thinks that a contractionary policy will follow during the second half of the year to cure what Salami calls fiscal hangover. Continuing deficit spending during the first half of the year, coupled with general uncertainty and capital flight, will maintain pressure on the exchange rate. As the naira depreciates during this time, Nigeria's heavy dependence on imports will induce a rise in inflation. This will cause continued erosion of asset prices, and savings will fall as a percentage of GDP. Given the relatively low level of foreign exchange, the Central Bank will be compelled to mop up excess liquidity and the attendant effect will be higher interest rates, if the rise is not suppressed by administrative fiat. In the light of these prospects, investors will be wary about imperiling dollar resources for naira; consequently, domestic and foreign investment in the non-oil sector in 2003 will be low relative to 2000-2001.

¶17. A few positive aspects may nevertheless emerge in ¶2003. The willingness of banks to devote 10 percent of their profits before tax to equity investments may boost investment in the real sector in 2003. In 2002 little was done with this pool of investible funds, which is building up, but creative initiatives by some banks and venture capital companies may lead to investments that will create employment. Additional jobs are likely to be created in 2003 by the next phase of the deregulation of the telecommunications sector as the second national carrier, Globalcom Ltd., begins to deploy facilities early in 2003.
Comment

¶18. One key issue highlighted by the reports given us is the paucity and unreliability of data. This is dramatized by the discrepancy between the projected growth rate for 2002 by the IMF (-0.9%) and the Central Bank of Nigeria (3.2%). While there is little the analyst can do about the poor data, it is important to footnote this defect and add the necessary caveats to the robustness of the analysis. While the central message of a possible cloudy outcome is right on the mark, analytical focus on the fiscal and fiscal policy stance and foreign account suggests that Nigeria's economic outcome is almost solely the result of policy. A rigorous decomposition of the structure of the economy shows, however, that the oil and agricultural sectors account for about 60 percent of the GDP, and performance in both sectors is not driven essentially by monetary and fiscal policies. Performance in the oil sector is primarily driven by OPEC and international oil prices, while agriculture is still largely weather dependent (recall the basis for the IMF-Central Bank of Nigeria huge discrepancy on 2002 growth rate). Much of Salami's and Utomi's analysis focuses on the formal (largely manufacturing) sector, but manufacturing account for barely 5 percent of GDP. This is this kind of structural analysis that leads us to put the appropriate caveats to the gloomy forecast; it is possible for economic performance to significantly improve even without any improvement in policy.

¶19. Nevertheless, Salami's and Utomi's presentation of late November echoed warnings we have heard from other

experts about the continuing structural imbalances within the economy. Government deficits accommodated by monetary policy perpetuate these imbalances. These will become even more apparent should oil revenues fall. Many countries engage in deficit spending to stimulate growth; in Nigeria, however, public spending is largely ineffective at increasing sustainable development. The reason is that so little of those public funds are channeled into productive investment. Moreover, government spending disproportionately favors the richest four-percent of the population identified earlier. These people tend to travel abroad and account for a disproportionate share of imports. These factors will put additional pressure on the naira. Since the rich generally seek to convert naira into foreign exchange quickly when they have large volumes of Nigerian currency (as many did so recently during the political party conventions), to reduce exchange rate risk and because forex is less bulky, the naira will surely depreciate during the coming months. Conversely, interest rates will remain high to attract capital inflows. So it is to be feared that instead of stimulating growth, excessive government spending will crowd out the private sector, which will force companies to scramble for funds at high interest rates.

¶20. High interest rates will affect not only the private sector. The cost of government borrowing will also remain high. Consequently, investment in infrastructure (roads, education, and public health) which has been badly neglected during the last several years may continue to be so. An Emboff who has accumulated eight years in Nigeria believes that its infrastructure is generally decaying. What is certain is that new investment is insufficient to cover the needs generated by population growth and depreciation of existing assets. To redress this situation, fiscal policy as it has been implemented throughout the last ten years must change.

¶21. Improving fiscal policy would call for public service reform and a budgetary process based on a better appreciation of economic principles. We have often heard Nigerian economists criticize their government's budget formulators for establishing budgets premised on one scenario and usually based upon a single oil price. Many of these economists recommend that budgets be based on multiple scenarios with clearly defined trigger points. For our part, we think that the GON should encourage the Central Bank to issue a directive to banks informing them that any and all future lending to states and local governments would be at their risk. The federal government would thus offer no guarantee and would refuse to "deduct at source" (i.e., before disbursements from the Federation Account) any payments on such debt. The Central Bank could also issue a "caveat emptor" notice to international banks to discourage lending to states. While such actions by the Central Bank would annoy some state-level politicians, there would be little they might do about it. (Few local governments are in a position to borrow.) Assuming such actions led to a modification of Nigeria's budgetary practices, it would not only reduce uncertainty; it would also reassure observers that while they may not see improvement in the next quarter or two, subsequent quarters might hold promise of a brighter future.

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